

EXHIBIT 2

CFTC REGULATION OF HEDGE FUNDS AND COMMODITY FUNDS

I. Introduction

The regulatory framework administered by the Commodity Futures Trading Commission ("CFTC") governs collective investment vehicles that engage in futures transactions, which are known as "commodity pools." Commodity pools may include investment funds that invest primarily in securities or other types of investments, as well as in futures. Consequently, hedge funds and similar vehicles may be subject to CFTC regulation. This outline addresses the CFTC's regulatory framework as it applies to hedge funds that engage in futures transactions and other investment vehicles subject to the CFTC's regulatory framework, including various exemptions that may be available.

A. Definitions

1. Commodity Pool Operator and Commodity Pool

a. Commodity Pool Operator ("CPO")

The Commodity Exchange Act ("CEA")¹ does not define the term "commodity pool." However, the CEA defines the term "commodity pool operator" as "any person engaged in a business that is of the nature of an investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in any commodity for future delivery on or subject to the rules of any contract market, except that the term does not include such persons not within the intent of the definition of the term as the Commission may specify by rule, regulation, or order." 7 U.S.C. § 1a(4).

b. Commodity Pool

CFTC Rule 4.10(d) defines a commodity pool as "any investment trust, syndicate or similar form of enterprise operated for the purpose of trading commodity interests."
17 C.F.R. § 4.10(d).²

¹ 7 U.S.C. § 1 et seq. (1994).

² CFTC rules referred to herein are found at 17 C.F.R. Ch. I (1998).

2. "Hedge Fund"

The term "hedge fund" is not defined or separately addressed by the CEA or the CFTC's regulations. The term "hedge fund" is said to have originated in the 1960's to refer to new types of speculative investment vehicles using sophisticated hedging and arbitrage techniques in the corporate equities market.³ Originally, the phrase "hedge fund" was used to reflect the fact that a principal investment technique of these funds was to contemporaneously buy and sell related equity securities, thus maintaining a "hedged" position. Today, of course, hedge funds employ a variety of speculative trading strategies involving the cash, futures and options markets, including transactions in foreign currencies, government securities and commodity transactions, as well as merger and acquisition activities.

B. Organization of Commodity Pools and Hedge Funds

1. Hedge funds, which also may be commodity pools, generally have been organized as limited partnerships. More recently, they also have been organized as limited liability companies. Typically, hedge funds are organized so as to avoid the application of most securities laws.
 - a. Although the interests sold in hedge funds are securities, hedge funds generally have sought to operate pursuant to Section 3(c)(1) of the Investment Company Act of 1940 ("ICA"), which provides an exception from the definition of "investment company" for "any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of securities." More recently, hedge funds also are being operated pursuant Section 3(c)(7) of the ICA, which provides a definitional exception where all of the participants in the fund are "qualified purchasers" as defined in Section 2(a)(51) of the ICA.

³ See generally Joint Report on the Government Securities Market (Department of the Treasury, Securities and Exchange Commission and Board of Governors of the Federal Reserve System, January 1992); Susan C. Ervin, The Perils of Success: Public Policy Issues Presented by Hedge Funds, Futures & Derivatives Law Report, Vol. 16, Nos. 1 & 2 (March/April 1996), at 8; Statement of Barbara Pedersen Holum, Acting Chairman, Commodity Futures Trading Commission, Before the House of Representatives Committee on Banking, Finance and Urban Affairs, April 13, 1994 (discussing hedge funds and their use of derivative products).

- b. Hedge funds also generally rely upon an exclusion from registration as securities dealers under Section 15(a) of the Securities Act of 1933 ("1933 Act"), based upon the "trader" exception to the definition of "dealer." In general, a trader is an entity that trades securities solely for its own investment account and does not carry on a public securities business.
 - c. Hedge funds may also avoid registration requirements under the 1933 Act pursuant to the Regulation D "safe harbor."
2. The CEA and CFTC regulations do not provide general exclusions from registration or regulation that are comparable to those available to hedge funds under the securities laws. Consequently, absent relief (based on, e.g., a strictly de minimis level of commodity interest trading) a hedge fund that trades futures, will be considered a commodity pool, and its operator will be required to register with the CFTC as a CPO.⁴ Once registered, a CPO must comply with CFTC disclosure, reporting and recordkeeping requirements, subject to the exemptions discussed in Sections II-IV, below.

C. Registration of CPOs

The CEA's registration requirements are a cornerstone of the regulatory framework enacted by Congress.

- 1. Applicants for registration as a CPO, the applicant's principals, and applicants for registration as salespersons ("associated persons") of a CPO, must file information on their employment background and disciplinary histories, as well as fingerprint cards for fitness screening through the Federal Bureau of Investigation database. These registration requirements preclude persons with statutorily specified criminal or civil disciplinary histories from operating or soliciting on behalf of commodity pools. 7 U.S.C. §§ 8a(2) and (3).
- 2. Registration applications are processed by the National Futures Association ("NFA").

⁴ On occasion, based upon very fact specific criteria, the Division of Trading and Markets has taken a CPO registration no-action position where, e.g., the hedge fund would commit a de minimis amount of its assets to establish commodity interest positions and its trading would be solely for bona fide hedging purposes. See, e.g., CFTC Interpretative Letter No. 97-79, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,167 (September 29, 1997).

3. A CPO applicant and any associated person employed by the applicant must pass the National Commodity Futures Examination (the "Series 3" examination), a proficiency examination prepared by the NFA and administered by the National Association of Securities Dealers Regulation, Inc.
4. Each registered CPO and associated person thereof also must attend mandatory ethics training upon registration and every three years thereafter. 17 C.F.R. § 3.34.

D. Disclosure, Reporting and Recordkeeping Requirements

Each registered CPO (or person required to be registered as a CPO) soliciting prospective investors must, absent an exemption, provide the prospective participant and file with the CFTC a Disclosure Document containing information specified in CFTC rules.

1. Disclosure Document

The Disclosure Document must include information concerning such matters as the risks relevant to investment in the pool; the business background of the CPO and its principals; the CPO's and the pool's historical performance results; fees to be incurred by the pool; conflicts of interest on the part of the CPO, commodity trading advisors ("CTAs") and other commodity professionals who will provide services to the pool; and material legal proceedings against the CPO, CTAs for the pool and other relevant persons during the past five years. 17 C.F.R. §§4.21, 4.24, 4.25 and 4.26.

2. Periodic Account Statements and Annual Reports

Registered CPOs must provide pool participants with an account statement at least quarterly (or monthly for pools with net assets exceeding \$500,000). Financial statements in annual reports must be prepared in accordance with generally accepted accounting principles and certified by an independent financial accountant, and the annual report must be provided to pool participants and filed with the CFTC. 17 C.F.R. § 4.22.

3. Recordkeeping Requirements

Registered CPOs must make and keep specified books and records at their main business office and make them available for inspection by the CFTC and the United States Department of Justice. With respect to each fund operated, registered CPOs must make and keep records including the

following: an itemized daily record of each commodity interest transaction of the pool; a journal of original entry of all receipts and disbursements of money, securities and other property; general ledgers of all asset, liability, expense and income accounts; transaction confirmations, purchase and sale statements and monthly statements received from futures commission merchants ("FCMs"); cancelled checks and bank statements; and all other records, data and memoranda prepared or received in connection with the operation of the pool. 17 C.F.R. § 4.23.

II. Rule 4.7(a): Exemption from Certain Part 4 Requirements With Respect to Pools Whose Participants are Limited to Qualified Eligible Participants

Rule 4.7(a) provides an exemption from the specific disclosure requirements of Rules 4.21, 4.24, 4.25 and 4.26, the reporting requirements of Rule 4.22 and the recordkeeping requirements of Rule 4.23 in connection with the operation of qualifying pools offered only to "qualified eligible participants" ("QEPs") as defined in the rule. CPOs who obtain relief pursuant to Rule 4.7(a), however, remain subject to a duty to disclose all material information as well as to the antifraud provisions of Section 40 of the CEA. 7 U.S.C. § 60. To claim relief under Rule 4.7(a), CPOs are required to file a notice of claim for exemption containing specified representations. The claim of relief generally is effective upon filing.

A. QEP Definition Generally, QEPs are defined to include:

1. Certain investment professionals, including FCMs registered pursuant to Section 4d of the CEA and brokers and dealers registered pursuant to Section 15 of the Securities Exchange Act of 1934, as well as registered CPOs and CTAs meeting certain criteria;
2. Persons who the CPO reasonably believes, at the time of sale to that person of a participation in an exempt pool, meet a substantial portfolio requirement (\$2,000,000 in securities or \$200,000 in exchange-specified initial futures margin and commodity option premiums on deposit at an FCM at any time during the preceding six months) and who come within specified categories of "accredited investors" as defined in Rule 501 of Regulation D under the 1933 Act; and
3. Non-United States persons,⁵ based upon their status as such and without

⁵ For purposes of the Rule 4.7 QEP definition, the following persons are not considered to be United States persons:

(1) a natural person who is not a resident of the United States;

regard to whether they would meet the portfolio or other financial qualification requirements.

B. No-Action Relief Permitting Certain Types of Non-QEPs to Participate in Rule 4.7 Exempt Pools

Since the adoption of Rule 4.7, the Division of Trading and Markets ("Division") has issued a number of "no-action" positions permitting registered CPOs to claim relief under Rule 4.7 with respect to a pool notwithstanding the fact that not all of the participants in the pool were QEPs.⁶ In the following situations, the Division confirmed that it would not recommend that the CFTC commence enforcement action against the pool's CPO for failure to comply with Rule 4.7 based solely upon the presence in the pool of non-QEPs in the following categories: (1) an accredited investor who, among other things, had been a limited partner in the pool for ten years and had been an independent director of a regis-

(2) a partnership, corporation or other entity, other than an entity organized principally for passive investment, organized under the laws of a foreign jurisdiction and which has its principal place of business in a foreign jurisdiction;

(3) an estate or trust, the income of which is not subject to United States income tax regardless of source;

(4) an entity organized principally for passive investment such as a pool, investment company or other similar entity Provided, That units of participation in the entity held by United States persons represent in the aggregate less than 10% of the beneficial interest in the entity, and that such entity was not formed principally for the purpose of facilitating investment by United States persons in a pool with respect to which the operator is exempt from certain requirements of Part 4 of the Commission's regulations by virtue of its participants being non-United States persons; and

(5) a pension plan for the employees, officers or principals of an entity organized and with its principal place of business outside the United States.

⁶ In some of the pools subject to these positions, non-QEPs had been participants before Rule 4.7 was adopted. In other cases, the non-QEPs sought to become participants in pools offered subsequent to the adoption of Rule 4.7. More recently, under the authority delegated to it by Rule 140.93, the Division has been issuing exemptive relief that permits a CPO of a Rule 4.7 pool to treat certain persons as QEPs who would not otherwise be able to participate in the pool.

tered series investment company sponsored by an affiliate of the CPO;⁷ (2) a corporate and securities law attorney with twenty years' experience who was the engagement partner for the pool;⁸ (3) a charitable foundation whose investment decisions were made by a QEP who had net worth exceeding \$25 million;⁹ (4) an accredited investor who was a certified public accountant and had prepared the pool's disclosure document, financial reports and records and worked closely with the CPO in the operation of the pool;¹⁰ and (5) professional employees of the CPO who were closely involved with the activities of the fund and who had access to all of the fund's books and records.¹¹

Each of these fact situations was presented in the context of an individual pool offering and it cannot be assumed that in any given pool non-QEPs in all of the categories set forth above, or multiple categories, would be permitted to participate in an exempt pool.

C. Application of Rule 4.7 to Existing Pools

1. Exemption Claim Filed After Offering of Pool Participations

Rule 4.7(a)(3)(i)(I)(2) provides that, as to pools that have been previously offered in full compliance with Part 4 and that otherwise qualify for exemption under Rule 4.7, a notice of claim for exemption may be filed with the CFTC at any time, provided that: the claim for exemption is otherwise consistent with the duties of the CPO and the rights of pool participants and the CPO notifies the pool participants of his intention, absent objection by the holders of a majority of the units of participation in the pool who are unaffiliated with the CPO within twenty-one days after the date of notification, to file a notice of claim for exemption under

⁷ CFTC Interpretative Letter No. 94-4, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,944 (December 27, 1993).

⁸ CFTC Interpretative Letter No. 94-1, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,941 (December 27, 1993).

⁹ CFTC Interpretative Letter No. 95-72, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,502 (August 21, 1995).

¹⁰ CFTC Interpretative Letter No. 93-42, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,733 (April 26, 1993).

¹¹ CFTC Interpretative Letter No. 96-14, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,625 (January 29, 1996); CFTC Interpretative Letter No. 96-6, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,608 (December 11, 1995).

Rule 4.7, and such holders have not objected within the twenty-one day period. A CPO filing a notice under this paragraph must either provide disclosure and reporting in accordance with the requirements of Part 4 to those participants objecting to the filing of the claim for exemption or allow objecting participants to redeem their units of participation in the pool within three months of the filing of the notice of claim for exemption.

2. Exemption Claims Where Pool Previously Offered to Non-QEPs and QEPs

Pursuant to Advisory 2-93,¹² CPOs are permitted to claim relief under Rule 4.7 for previously offered pools that have non-QEP participants by filing the notice of claim for exemption required by Rule 4.7(a)(3) and using the procedure set forth in Rule 4.7(a)(3)(i)(I)(2) discussed above, provided that: (1) all new participants in the pool will be QEPs; (2) the CPO will continue to provide non-QEPs and objecting QEPs who are already participants in the pool with the disclosure and reports, and will maintain the books and records, required under Part 4 for pools that are not operated pursuant to Rule 4.7; (3) the CPO will modify the statement required by Rule 4.7(a)(2)(i) as specified in the Advisory and will not claim exemption from disclosing in the disclosure document of non-exempt pools the past performance of the pool so long as the pool has any participants who were not QEPs when Rule 4.7 relief was claimed; and (4) the notice of claim for exemption states that the pool for which relief is claimed includes non-QEPs and

that the CPO will comply with the applicable requirements of Rule 4.7 as modified by, and under the conditions set forth in, the Advisory.

D. Waiver of Ten Percent Limitation

Rule 4.7(a)(1)(ii)(B)(2)(xi) provides that a pool that is a QEP may not invest more than ten percent of its assets in Rule 4.7 exempt pools unless all participants in the pool are QEPs. On several occasions, the Division has permitted departures from this ten percent investment limitation. In one case, the non-QEPs in the QEP pool, who were employees of the CPO in executive or trading positions, were represented to be knowledgeable about the commodities and securities industries, were familiar with the CPO's operations and had ready access to information about the pool's operations. Prior to making such investment, the CPO was required to notify the non-QEPs of its intention to do so and to give them an opportunity to redeem their interests in the pool within ten days of receipt of the notice.¹³ In another case, the Division granted a CPO relief

^{12/} CFTC Advisory for Interpretative Letters Nos. 93-1 and 93-2, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,935 (January 7, 1993).

¹³ CFTC Interpretative Letter No. 94-19, [1992-1994 Transfer Binder] Comm. Fut. L. Rep.

from the ten percent limitation with respect to a Rule 4.7 fund that was not comprised solely of QEPs provided that it notified all non-QEP investors in the fund that the fund may invest more than ten percent of its assets in pools that are operated pursuant to Rule 4.7.¹⁴ Recently, the Division permitted a fund that was a QEP, but subject to the ten percent limitation, to invest 39% of its assets in a Rule 4.7 pool that was formed by the same CPO.¹⁵ In this case, since both funds were operated by the same CPO, who had complete access to all the information concerning both funds, such CPO could assure that the non-QEP participants in the investor fund would receive all of the necessary disclosures concerning the Rule 4.7 pool.

III. Rule 4.12(b): Exemption for Pools Primarily Engaged in Securities Transactions

Rule 4.12(b) provides narrower exemptive relief than Rule 4.7 but is likely to be available to a broader range of investment vehicles. As the rationale for Rule 4.7 relief is the substantial financial wherewithal and presumed sophistication of the pool's participants, the predicate for the Rule 4.12(b) exemption is that the fund's primary investment activity is in securities, that the fund's futures activity is limited and incidental to its securities trading activities and that compliance with applicable securities requirements can therefore be relied upon in lieu of compliance with certain CFTC requirements. Rule 4.12(b) relief is available to registered CPOs who operate pools which: (1) are offered and sold pursuant to the 1933 Act or an exemption therefrom; (2) are generally and routinely engaged in the buying and selling of securities and "securities derived instruments;" (3) do not commit more than ten percent of the fair market value of their assets to establish commodity futures or option positions; and (4) will trade commodity futures or options in a manner solely incidental to their securities trading.¹⁶

To obtain Rule 4.12(b) relief, the CPO must file a written claim for exemption identifying the CPO and the pool for which relief is being claimed and containing representations that the pool will be operated in accordance with the requirements of the rule. The claim of relief is effective upon filing.

(CCH) ¶ 26,000 (November 24, 1993).

¹⁴ CFTC Interpretative Letter No. 96-20, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,632 (February 27, 1996).

¹⁵ CFTC Interpretative Letter No. 96-59, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,764 (July 23, 1996).

¹⁶ It would not be uncommon for a pool to meet the criteria for relief under both Rule 4.12(b) and Rule 4.7. Because Rule 4.12(b) provides narrower exemptive relief than Rule 4.7, in all likelihood the CPO of the pool would claim the broader relief available under Rule 4.7.

A. Scope of Exemptive Relief

If a pool qualifies for exemption under Rule 4.12(b), the CPO may with respect to that pool: (1) use an offering memorandum prepared in accordance with the 1933 Act or a relevant exemption therefrom, supplemented by certain, but not all, disclosures otherwise required by the CFTC; (2) provide a quarterly statement indicating the net asset value of the pool as of the end of the reporting period and the change in net asset value from the end of the previous reporting period, in lieu of the prescribed account statement; (3) provide in lieu of the prescribed annual report a certified annual report which contains, at a minimum, Statements of Financial Condition and of Income (Loss); and (4) claim exemption from certain recordkeeping requirements.¹⁷ Perhaps most notably, the disclosure relief available under Rule 4.12(b) includes relief from providing certain past performance disclosures otherwise required by Rule 4.25.

B. Applying the Ten Percent Futures Margin Limitation

The Division has stated that in applying the Rule 4.12(b) ten percent limitation upon initial futures margin and commodity option premiums in the context of a Rule 4.12(b) exempt pool investing indirectly in futures or commodity options by investing in other Rule 4.12(b) exempt pools, the investor pool may calculate the extent of its commitment of funds to futures margin by multiplying the amount of its capital allocated to investments in other Rule 4.12(b) pools by ten percent.¹⁸

C. Rule 4.8 Pre-Filing Exemption

Rule 4.8 provides relief from the Rule 4.26(d) requirement of filing a pool's disclosure document with the CFTC twenty-one days in advance of use for pools that are offered in securities offerings exempt from registration under the 1933 Act pursuant to Rules 505 or 506 of Regulation D and operated in accordance with Rule 4.12(b).¹⁹ Such funds may be offered upon filing of the disclosure document with the CFTC and providing the document to prospective participants.

¹⁷ Specifically, the requirements of Rule 4.23(a)(10) and (a)(11), which relate to Statements of Financial Condition and Statements of Income (Loss).

¹⁸ CFTC Interpretative Letter No. 91-6, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,069 (June 13, 1991).

¹⁹ Rule 4.8 also provides relief from the twenty-one day pre-filing requirement with respect to pools that are offered pursuant to Rules 505 or 506 of Regulation D and offered or sold only to accredited investors, whether or not the pool is exempt under Rule 4.12(b).

IV. Advisory 18-96: Offshore Commodity Pool Relief for Certain Registered CPOs from Rules 4.21, 4.22 and 4.23(a)(10) and (a)(11) and from the Location of Books and Records Requirement of Rule 4.23

The CPOs of hedge funds and other investment vehicles that are domiciled “offshore” may obtain relief from disclosure, reporting and recordkeeping requirements pursuant to Advisory 18-96.²⁰ The first part of the Advisory generally extends relief to qualifying CPOs from the disclosure, reporting and recordkeeping requirements of Rules 4.21, 4.22 and 4.23(a)(10) and (a)(11), respectively, which the CFTC's Division of Trading and Markets has previously issued on a case-by-case basis, based upon certain representations concerning the location and operation of the fund. The second part of the Advisory provides relief for certain registered CPOs from the requirement that an offshore fund's books and records be kept at the main business office of the CPO.

- A. Persons may claim relief under Section (A) of Advisory 18-96 if they meet the following criteria:
1. the CPO is registered with the CFTC as a CPO;
 2. the fund is, and will remain, organized and operated outside of the United States;
 3. the fund will not hold meetings or conduct administrative activities within the United States;
 4. no shareholder of or other participant in the fund is or will be a United States person;
 5. the fund will not receive, hold or invest any capital directly or indirectly contributed from sources within the United States; and
 6. the CPO, the fund and any person affiliated therewith will not undertake any marketing activity for the purpose, or that could reasonably be expected to have the effect, of soliciting participation from United States persons.
- B. A registered CPO whose main business office is within the United States and who operates a fund that has its main business outside of the United States may obtain relief from the requirement of Rule 4.23 that a registered CPO maintain the

²⁰ CFTC Advisory No. 18-96, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,659 (April 11, 1996).

original books and records of its fund at its main business office through the filing of a notice of a claim for exemption with the Division that sets forth the following representations:

1. the CPO will maintain the original books and records of the fund at the main office of the fund located outside the United States;
 2. the CPO desires to maintain such books and records outside the United States in furtherance of compliance with Internal Revenue Service ("IRS") requirements for relief from United States federal income taxation;²¹
 3. the CPO will maintain duplicate books and records of the fund at a designated office in the United States; and
 4. within 72 hours after the request of a representative of the CFTC, the United States Department of Justice or the National Futures Association, the original books and records of the fund will be provided to such representative at a place located in the United States that is specified by the representative.
- C. Persons claiming relief pursuant to Advisory 18-96 remain subject to all other applicable requirements contained in the CEA and the CFTC's regulations thereunder, including, without limitation, the antifraud provisions of Sections 4b and 4g of the CEA, the reporting requirements for traders set forth in Parts 15, 18 and 19 of the CFTC's regulations, and all other provisions of Part 4.

V. Market and Financial Integrity Regulations Applicable to Futures Market Participants

The CFTC has a comprehensive market surveillance system, which is designed to maintain freely competitive markets by detecting and preventing threats of price manipulation, excessive speculation, or other major market disruptions caused by abusive trading practices.²² This system includes various requirements that apply to traders in the

²¹ At the time the Advisory was issued, the Internal Revenue Code and associated regulations provided that to be relieved from U.S. federal income taxation, a foreign fund would be required, among other things, to keep its books and records offshore. The individual states also took this position with respect to relief from state taxation. Recently, Federal legislation was enacted eliminating this requirement. However, not every state has abandoned its position. Division staff currently is evaluating this situation to determine the best way to address it.

²² See generally CFTC Backgrounder 5-92, The CFTC Market Surveillance Program (July 1996); CFTC Backgrounder 3-92, Speculative Limits, Hedging and Aggregation in Agricultural

futures markets generally, without regard to whether they are commodity pools or other regulated entities.

A. Speculative Position Limits

1. Statutory Authority

Section 4a(a) of the CEA states that “[e]xcessive speculation in any commodity under contracts of sale of such commodity for future delivery made on or subject to the rules of contract markets causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden on interstate commerce in such commodity.” 7 U.S.C. § 6a(a). For the purpose of “diminishing, eliminating, or preventing such burden,” the CFTC is authorized to set “limits on the amounts of trading which may be done or positions which may be held by any person,” including a CPO.

2. Requirements

The CFTC as well as the contract markets impose speculative position limits to prevent market distortions.²³ Commodity funds, including hedge funds, however, may obtain exemptions from the CFTC's speculative position limits provided that they can demonstrate that they have price risks associated with cash market positions that they wish to hedge or that they are engaging in arbitrage activity that may be eligible for an exemption.²⁴ 17 C.F.R. § 150.3(a).

Commodity Futures and Options (July 1996). Copies of these Backgrounders may be obtained from the CFTC's Web site, at www.cftc.gov.

²³ The CFTC's speculative position limits, which are solely on agricultural commodities, are found at 17 C.F.R. Part 150. In addition, each contract market is required to establish speculative position limits, subject to CFTC approval (or exemption), for those contracts not specified in part 150. 17 C.F.R. § 1.61.

²⁴ As a practical matter, hedge funds are unlikely to satisfy the criteria for exemption from the CFTC's speculative position limits because they generally do not have bona fide cash positions in certain agricultural markets, such as corn or cotton. Hedge funds, however, may be able to obtain an exemption from the *contract market* speculative position limits if such funds have certain portfolios that they wish to hedge. As discussed in the next paragraph, for certain markets speculative position limits have been replaced by “position accountability rules.”

a. Position Accountability Rules

In certain contract markets, such as those for United States Treasury bond, foreign currencies and precious metals, speculative position limits have been replaced by position accountability rules. See 51 Fed. Reg. 51867 (October 15, 1991). Position accountability rules require traders who own or control positions in excess of exchange established limits to provide to the exchange, upon request, information regarding the nature of the position and the trading strategy employed.

3. Aggregation

The CFTC's position limits apply to all positions in accounts for which any person by power of attorney or otherwise directly or indirectly holds positions or controls trading or to positions held by two or more persons acting pursuant to an expressed or implied agreement or understanding, the same as if the positions were held by, or the trading of the positions were done by, a single individual. 17 C.F.R. § 150.4. Rule 150.3 provides an exemption to permit control-based application of speculative position limits with respect to funds which use multiple independent account controllers. 17 C.F.R. § 150.3(a).

B. Large Trader Reporting System

1. Statutory Authority

Section 4i of the CEA makes it unlawful for any person to hold a "reportable" futures position, i.e., a position which equals or exceeds the quantities specified in CFTC rules, unless such person has filed reports of those positions in accordance with CFTC rules. 7 U.S.C. § 6i.

2. Daily Reporting by FCMs, Clearing Members and Foreign Brokers

Each FCM, clearing member and foreign broker shall submit a report to the CFTC each business day with respect to each account for which there is a "reportable" position, except for accounts carried on the books of another FCM on a fully disclosed basis. 17 C.F.R. § 17.00. Additionally, the contract markets report to the CFTC each business day, by proprietary and customer account, on the positions that each clearing member is carrying. 17 C.F.R. § 16.00.

3. Requirements for CPOs

Each CPO who holds a "reportable" position is required to file with the CFTC information, including the name and address of the reporting trader; principal business and occupation of the reporting trader; the name and address of each person whose option or futures trading is controlled by the reporting trader; the name and address of each person who controls the trading of the reporting trader; and the names and locations of persons who guarantee the futures or option trading accounts or who have a financial interest of ten percent or more in the reporting trader or accounts of the reporting trader. 17 C.F.R. § 18.04.

4. Aggregation

Positions held in a commodity pool operated by a CPO, other than a CPO who is an officer, partner or employee of an FCM, shall be considered positions controlled by such CPO unless: (1) a trader other than the CPO directs the trading for such commodity pool; (2) the CPO maintains only such control over trading in the commodity pool as is necessary to fulfill its duty to supervise diligently all accounts of the pool; and (3) each trading decision of the commodity pool is determined independently of all trading decisions in other commodity pools and positions in accounts which the commodity pool operator holds, has a financial interest in, or controls. 17 C.F.R. § 18.01(c).

However, if a CPO has a greater than ten percent interest in or controls more than one account, whether carried with the same or with different FCMs or foreign brokers, all such accounts shall be considered as a single account for the purpose of determining whether such trader has a reportable position and for the purpose of reporting. 17 C.F.R. § 18.01(a).

5. Inspection Powers

Section 4i of the CEA requires all traders with reportable futures positions to "keep books and records of all such transactions and positions in any such commodity traded on or subject to the rules of any board of trade, and of cash or spot transactions in, and inventories and purchase and sale commitments of such commodity." Further, such books and records are required to show complete details concerning all such transactions, positions, inventories, and commitments, including the names and addresses of all persons having any interest therein," and to be open all at all times to inspection by any representative of the CFTC or the Department of Justice. 7 U.S.C. § 6i; 17 C.F.R. § 18.05.

C. Emergency Powers

The CFTC has statutory authority to take emergency action when it finds that there is a threatened or actual manipulation or corner or "other major market disturbance which prevents the market from accurately reflecting the forces of supply and demand." 7 U.S.C. § 12a(9). The CFTC has exercised this power four times.

September 28, 1998